

**CATCHING UP WITH EASTERN EUROPE?  
THE EUROPEAN UNION'S MEDITER-  
RANEAN FREE TRADE INITIATIVE**

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## **Catching Up With Eastern Europe? The European Union's Mediterranean Free Trade Initiative**

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## Abstract

This paper discusses the potential role of a Euro-Mediterranean Agreement (EMA) in helping Middle East and North African governments implement structural economic reforms. The arguments for and against preferential liberalization are summarized, identifying a number of necessary conditions for an EMA to benefit a Mediterranean country. The recently negotiated EMA between Tunisia and the EU is evaluated, using these conditions as criteria. Some doubts are expressed regarding the benefits of an EMA and the extent it will help countries in the region "catch up" with those in Central and Eastern Europe. Significant supporting and complementary actions are likely to be needed. Key issues in this connection are the regulatory regimes applying to inward foreign direct investment (FDI) and the service sector; a reduction in tariffs applied to the rest of the world; and the imposition of hard budget constraints on state-owned enterprises. These aspects are not subject to disciplines under the EMA.

## ملخص

تبحث هذه الورقة الدور الذي يحتمل أن تلعبه اتفاقية بين أوروبا ودول حوض البحر الأبيض المتوسط في مساعدة حكومات دول الشرق الأوسط وشمال أفريقيا على تطبيق الإصلاحات الاقتصادية الهيكلية. ويتم تلخيص الحجج المؤيدة والرافضة للتحرير التفضيلي، مع تحديد عدد من الشروط اللازمة لكي تنتفع دول حوض البحر الأبيض المتوسط باتفاقية أوروبية-أوسطية. وتم في هذه الورقة استخدام هذه الشروط كمعايير لتقييم الاتفاقية التي تم التفاوض عليها مؤخراً بين تونس والاتحاد الأوروبي. وتم التعبير عن بعض الشكوك المتعلقة بمميزات اتفاقية بين أوروبا ودول حوض البحر الأبيض المتوسط ومدى قدرتها على مساعدة دول المنطقة على اللحاق بدول وسط أوروبا وشرقها. فربما يحتاج هذا الأمر اللجوء إلى إجراءات تكاملية ومساندة. ومن الأمور الأساسية في هذا المضمار أدوات النظم التي تطبق على الاستثمار الخارجي المباشر المتجه نحو الداخل، وعلى قطاع الخدمات، وتخفيض في الجمارك يتم على المستوى العالمي، وفرض قيود على ميزانيات المؤسسات المملوكة للدولة. وتلك أمور لا تخضع لنظم الاتفاقية بين أوروبا ودول حوض البحر الأبيض المتوسط.

## I. INTRODUCTION

There has been a marked shift in many countries since the early 1980s towards liberalizing international trade. To a large extent this reflects a recognition that such intervention is often not only inefficient, but also ineffective and counterproductive. Governments around the globe are increasingly seeking to create an enabling environment allowing private individuals and firms to employ the nation's resources more efficiently. This enabling environment includes the provision of public goods such as a stable, business-friendly legal framework that allows contracts to be enforced rapidly and at low cost; a regulatory regime that fosters and maintains competition on product and factor markets; and the provision of basic education and health services. While trade liberalization is a powerful instrument for increasing competition, formal trade policies such as the level and dispersion of the tariff are only one aspect of the trade regime. As important are trade *institutions*: the framework in which policies are determined and the administrative mechanisms through which they are implemented and enforced. Traders need to confront as little uncertainty as possible regarding the rules that apply, the taxes that must be paid, or the time taken up by customs clearance.

The major policy issue facing many of the countries in the MENA region is to follow the rest of the world in liberalizing, privatizing and deregulating markets. The role of the public sector in many MENA countries is still pervasive. In some parts of the region the public sector accounts for more than one-half of GDP, and employs over 60 percent of skilled workers (World Bank, 1995a). Trade barriers remain high. Average taxes on trade are around 15 percent, more than twice the level applying in Eastern Europe (Appendix Table 1). Para-tariffs of many kinds are prevalent, reducing the transparency of the trade regime. A basic tenet of economic reform efforts undertaken in the last decade in many countries of the region has been that reform be gradual. Given that gradual trade reform has often not been accompanied by actions to significantly reduce the role of the State in the economy, reform efforts have had a limited impact in terms of effectively increasing competition on product markets (Hoekman, 1995a). The slower the pace of economic reform and the less comprehensive its scope, the larger the gap between MENA's performance and that of the rest of the world is likely to become. The implicit rationale for gradualism in the region appears to be a perception that a "big bang" approach is not feasible politically.<sup>1</sup> What is needed is an institutional framework that enhances the credibility of a gradual reform strategy and thus ensures the needed supply response. The World Trade Organization (WTO) and the European Union's (EU) offer to establish a Euro-Mediterranean Economic Area are particularly relevant in this regard.

The need for reform is clear--economic performance has been lagging, and the incentive regime is steadily falling behind that of comparator countries (World Bank, 1995a). The aim of this paper is to discuss the potential role of a Euro-Mediterranean Agreement (EMA) in helping MENA governments implement structural economic reforms. It is organized as follows. Section II discusses the arguments for and against preferential liberalization in the MENA setting, comparing the potential costs and benefits of a multilateral (WTO) as opposed to a regional integration strategy. Section III describes the recent trade performance of Central and Eastern European countries (CEECs) to

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<sup>1</sup> That is to say, the economic situation has never deteriorated to such an extent that "shock therapy" was unavoidable.

illustrate the possible impact of opening up the economy to trade in the context of a free trade agreement (FTA) with the EU. Section IV turns to the recently negotiated EMA between Tunisia and the EU, and asks to what extent it will help Mediterranean countries catch up with the CEECs. Some doubts can be expressed in this connection if significant supporting and complementary actions are not taken. Key issues in this connection are the regulatory regimes applying to inward foreign direct investment (FDI) and the service sector, the magnitude of tariffs applied to the rest of the world (trade diversion), the extent of privatization, and the imposition of hard budget constraints on state-owned enterprises. Most of these aspects are not subject to disciplines under the EMA. Section V concludes.

## II. WHY GO REGIONAL?

There are a variety of options for governments seeking to liberalize trade and investment regimes, including unilateral action, multilateral liberalization based on reciprocity, and preferential (regional) liberalization. For a small country--one that cannot influence its terms of trade for most commodities--unilateral free trade is predicted by economic theory to be welfare superior to the other options. If, in the context of multilateral negotiations, other countries reciprocate, this will increase the gains from unilateral liberalization efforts. However, given the small country assumption--which applies to the countries in the region--there are few if any gains to be expected from making liberalization conditional upon reciprocity by trading partners. Preferential liberalization through the negotiation of a FTA will also be an inferior strategy. The reason is simple: the world market is always larger than a regional one. By not discriminating across potential trading partners, domestic firms and consumers will be allowed to buy goods and services from least cost suppliers, wherever they are located. By discriminating in favor of specific countries, the possibility arises of trade *diversion*--the elimination of tariffs for partner countries may induce consumers and firms to source from less efficient suppliers located in a partner country, rather than from the least cost source of supply. This may be offset by trade *creation*--a shift towards sourcing from more efficient suppliers in the partner country after the elimination of trade barriers. The point, however, is that through unilateral liberalization such losses do not occur, and the net gains are greater.

The case against regional (preferential) trade agreements is particularly strong in the context of small countries that already have duty free access to a large partner country market but maintain tariffs on imports originating in this partner country. This is the case for the Mediterranean countries, which were granted duty-free access to EU markets for industrial (non-agricultural) goods under Cooperation Agreements negotiated in the 1970s. In such cases, as argued by Panagariya (1995), Mediterranean countries that enter into a FTA with the EU will lose the tariff revenue presently collected on imports of EU origin. The EU accounts for 48 percent of total imports by all MENA countries, a share that will increase after the implementation of free trade with Europe. The revenue loss is therefore substantial. It is equivalent to a transfer from Mediterranean governments (consumers) to EU exporters. The static benefits arising from improved resource allocation are unlikely to offset this loss (see Panagariya, 1995). Of course, dynamic benefits (induced growth effects driven by increased factor accumulation) may well ensure that longer term returns are positive.

The point, again, is that these benefits can in principle also be attained through unilateral liberalization, without the associated losses.<sup>2</sup>

Although these are powerful logical arguments in favor of nondiscriminatory liberalization, many countries nonetheless pursue preferential trade agreements. What explains this? More importantly, what are the necessary conditions for regional integration to be welfare enhancing for the countries involved?<sup>3</sup> Possible economic explanations or motivations for regional integration are manifold. Five will be mentioned here. Before doing so, it must be recognized that regional integration is often driven by foreign policy and political considerations. Possible economic losses (inefficiencies) may be accepted as the price for attaining non-economic objectives. This aspect of regional integration is undoubtedly important in practice. From an economic perspective what matters then is that policymakers (and voters) have enough information to allow them to judge whether the non-economic benefits compensate for possible economic losses.

1. *Credibility and dynamic gains* A regional integration agreement (RIA) may offer a stronger mechanism for locking in (anchoring) economic reforms than the WTO. In part this may be because the RIA addresses policy areas that are not covered by the WTO at all, or where WTO disciplines are weak. For example, investment or factor market policies are not addressed by the WTO. WTO disciplines pertaining to services policies are relatively weak.<sup>4</sup> Thus, unilateral reforms in these areas may be anchored through a RIA in ways that are not available in the WTO. Even in the area of trade policies, the traditional domain of the GATT, WTO disciplines may be weaker than under a RIA. Credibility under the WTO arises in large part from the binding of tariffs. The most that can be done in this connection is to bind tariffs at applied rates. This is something most developing countries have not done, in part because of the mercantilistic bias of the GATT negotiating process (governments wanted to keep "negotiating chips"), and in part because many did not desire to be bound by GATT rules. Although there is a trend that governments are increasingly asked to reduce the difference between bound and applied rates, there is no requirement to bind at applied rates. Binding at applied rates has been a voluntary step for developing country governments. This in turn increased the political difficulty for governments to do so. In a RIA of the kind envisaged by the EU, binding is not voluntary, but required. A RIA may therefore help overcome internal political resistance to

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<sup>2</sup> The losses do not arise under unilateral liberalization because there is then no transfer of tariff revenue to EU firms. Instead, domestic consumers obtain a welfare gain as the tariff revenue equivalent accrues to them in the form of lower prices for goods.

<sup>3</sup> In what follows we abstract from the systemic or global welfare implications of regional integration. These are controversial and the subject of ongoing debate. See Bhagwati (1993) and the contributions in Anderson and Blackhurst (1993).

<sup>4</sup> See Hoekman (1995b) for a detailed analysis of the GATS.

binding and the mercantilistic biases of the GATT process.<sup>5</sup> It may also lead to greater credibility if monitoring and enforcement mechanisms are stronger.

The greater credibility that may be associated with a RIA, can lead to higher dynamic growth effects insofar as more investment is fostered, greater adjustment efforts are made, etc. These effects of enhanced credibility are of course the important dimension. Unfortunately, quantifying them is very difficult. However, the cross-border merger and acquisition activity that was associated with the EU's Single Market program in the late 1980s is indicative of the type of market response that may emerge following the initiation of a credible regional liberalization strategy.

2. *Harmonization* An important element of a RIA may consist of harmonizing regulatory regimes and administrative requirements relating to product standards, testing and certification procedures, mutual recognition agreements, common documents for customs clearance (e.g., the EU's Single Administrative Document), coordination and cooperation on linking computer systems of Customs, etc. These are areas where the WTO is restricted to general principles (i.e., national treatment and MFN). While such cooperative efforts can be pursued unilaterally, formal agreements may be necessary to induce the administrative bodies involved to cooperate. The associated reduction in trade and transactions costs will benefit all traders and consumers. Insofar as reductions in transactions costs are applied in a nondiscriminatory manner, trade diversion type issues do not arise.

3. *Security of market access* A benefit of a RIA may be that it allows the countries involved to agree to eliminate the possibility of imposing contingent protection, such as antidumping actions. To the extent that a substantial share of total trade is with partner countries, such agreement could be of great value. In the multilateral context such an agreement is unlikely to be feasible in the near future. Harmonization of administrative requirements and procedures may also help to improve the security of market access. An important area in this connection relates to product standards and their enforcement.

4. *Transfers* Another potential benefit of a RIA is that it may involve transfers from richer members to poorer ones. Such transfers may be financial, or take the form of technical assistance. To the extent that such transfers are conditional upon membership of the RIA (i.e., are *additional*), they will help offset the possible losses associated with the implicit transfer of tariff revenue and the costs of trade diversion. Additionality is important, and much may depend on how this is measured. For example, the Mediterranean countries already receive significant financial assistance from the EU, both through bilateral official aid, and through the Financial Protocols that are negotiated every 4 years under auspices of the Cooperation Agreements. It can be argued that what matters in this connection is the comparison between the present discounted value of the expected transfers under

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<sup>5</sup> Enforcement of binding commitments may also be stronger under a RIA. In GATT, the ultimate enforcement is retaliation by "principal suppliers," the countries with whom a tariff concession was originally negotiated. Such retaliation, if it occurs, will take the form of increases in tariffs on exports of the country violating a binding. This may not constitute a sufficient deterrent threat. Alternatively, the country may offer to compensate principal suppliers by lowering other tariffs (on an MFN basis). These mechanisms may not exist in the RIA context. In the EU context, a FTA will not make allowances for the permanent re-imposition of tariffs. GATT does.

status quo arrangements (Cooperation Agreements) and those that are expected under the new regime (the EMA). Given the generally declining trend in official aid, and the emergence of the CEECs as new "claimants," taking past transfers as the basis for an "additionality" test is probably unrealistic.

*5. Facilitation of general liberalization* A final, and very important potential rationale for regional integration along EMA lines is if it is used as part of a deliberate strategy to liberalize the economy more generally, i.e., on a most-favored-nation (MFN) basis. The possible loss associated with a EMA will be reduced if efforts are made to reduce trade barriers confronting non-partner countries. Adjustment costs associated with liberalization on an MFN basis are not likely to be much higher than those emerging from regional liberalization with the EU. The offer of financial and other assistance from the EU can then be used to facilitate the transition path to MFN reductions in trade barriers. Stated otherwise, the EMA may allow a government to enhance the political feasibility of MFN liberalization.

These are possible economic arguments favoring a regional strategy. The extent to which they are sufficient to ensure a welfare gain for a Mediterranean country is an empirical matter. It depends on the contents of the trade agreement that is negotiated, the magnitude of the additional financial and other types of transfers, and the intentions of the governments involved. In the Mediterranean context, necessary conditions for a Euro-Mediterranean Agreement (EMA) to be welfare improving is that the transfer of tariff revenue/trade diversion costs is offset; that the EMA goes significantly beyond the current WTO disciplines--especially in areas such as investment and services; and that significant progress will be made in the area of trade facilitation--customs procedures, documentary requirements, product testing and certification. To the extent that the security of market access is enhanced, this will strengthen the case in favor of regional integration. The next Section will discuss to what extent these necessary conditions appear to have been met. In general, most RIAs have not satisfied them. Indeed, historically preferential trade agreement generally have not gone much beyond the GATT (Hoekman and Leidy, 1993).

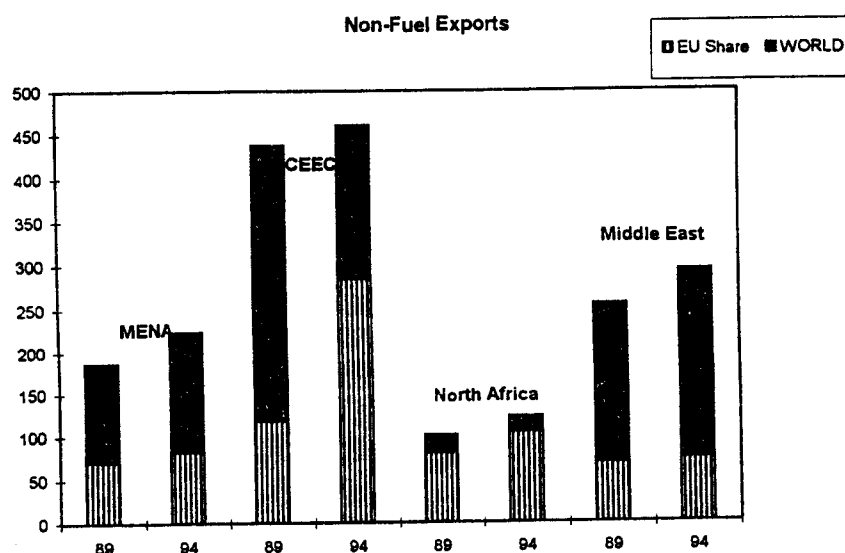
The possible loss associated with a EMA will be reduced the more competitive are EU suppliers, and the lower are the tariffs imposed on imports of EU goods by Mediterranean countries. The loss may be further reduced if efforts are made to reduce trade barriers confronting non-partner countries. Indeed, the importance of this cannot be over-emphasized. The strongest case that can be made in favor of regional integration along EMA lines is if it is used as part of a deliberate strategy to liberalize the economy more generally, i.e., on an MFN basis. Very much depends in this connection on the willingness of the government to state clearly that general, MFN liberalization of the trade regime is indeed its objective. If this is not done, incentives may easily be created for the formation of coalitions between EU and domestic firms that oppose further opening of the market to (more efficient) third country suppliers. As noted by Bhagwati (1993), they may argue that the regional market is "our" market, that outsiders trade "unfairly" because they are subject to a more lenient regulatory environment etc.



### III. THE EUROPE AGREEMENTS AND RECENT TRADE PERFORMANCE OF THE CEECs<sup>6</sup>

This Section briefly describes recent developments in MENA and CEEC trade with the European Union, exploring the impact of measures to open the economy to international trade. While the comparison is somewhat "unfair" given the greater level of industrialization and human capital that exists in Eastern Europe, the parallels between the two regions are close enough that a comparison is informative. Many countries in both regions start reforms in the late 1980s; the level of state intervention in both regions was high; and both are in proximity to the European Union. Moreover, although CMEA-based trade dominated in the CEEC context, it was also significant for a number of Mediterranean countries (e.g., Egypt). Clearly the similarities should not be exaggerated. But

Figure 1: Per Capita Exports 1989-94



1. North Africa = Algeria, Morocco and Tunisia.
2. Middle East = Egypt, Israel, Jordan, Kuwait, Lebanon, Syria and UAE
3. MENA = North Africa and Middle East.
4. CEEC = Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovak Republic

the CEEC experience is informative because it provides data on the possible impact of an EMA.

Per capita exports for the MENA region as a whole are around US \$225. They rose slightly between 1989 and 1994, with the share of exports going to the EU declining to 36.6 percent (Figure 1). MENA exports to the EU are largely due to North Africa, which exports most of its manufactured goods to Europe. For the Middle Eastern countries the EU is much less important. Although

<sup>6</sup> This Section summarizes and updates material contained in Hoekman (1995).

aggregate exports of the CEECs to the world initially declined after 1989--reflecting a large drop in output and exports as enterprises adjusted to price liberalization and the demise of centralized trade--by 1993 per capita exports exceeded 1989 levels again. Whereas only some 29 percent of CEEC exports went to the EU in 1989, the proportion had risen to over 60 percent in 1994. The average annual growth rate of exports to the EU (20.4 percent) is two and a half times that of MENA countries (Table 1).

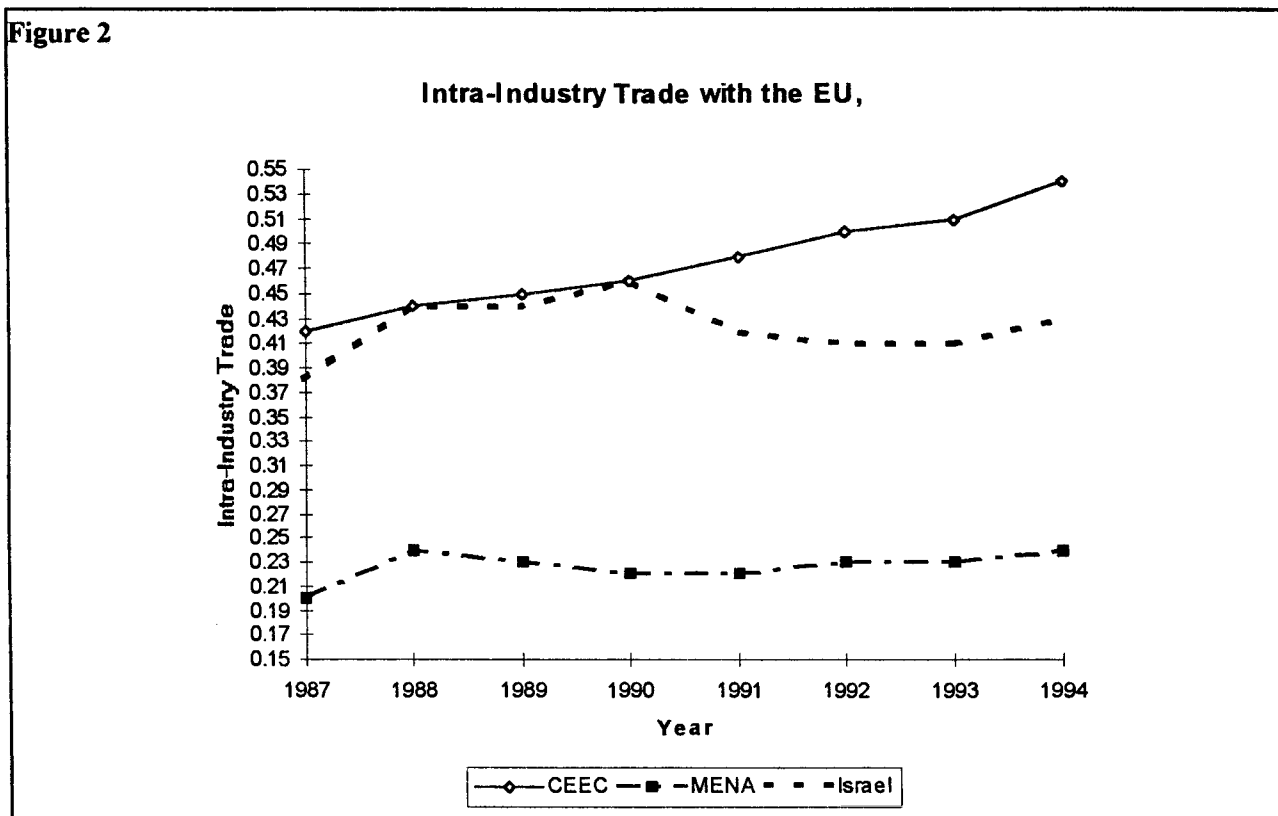
**Table 1: Non-Oil Exports to EU, 1989 and 1994 (ECU million)**

Country	Value			Market Share in EU	
	1989	1994	Growth	1989	1994
MENA	9,940	14,485	7.8	2.68	2.68
Jordan	86	152	12.1	0.02	0.03
Lebanon	100	87	-2.8	0.03	0.02
Syria	90	234	21.0	0.02	0.04
Israel	3,014	4,043	6.1	0.81	0.75
Egypt	790	1,107	6.9	0.21	0.20
Morocco	2,612	3,652	7.0	0.70	0.67
Tunisia	1,596	2,784	14.8	0.43	0.51
Algeria	219	328	8.4	0.06	0.06
Saudi Arabia	890	1,234	6.7	0.24	0.22
Kuwait	131	169	5.2	0.04	0.03
U.A.E.	414	695	10.9	0.11	0.12
CEEC	10,336	26,115	20.4	2.79	4.83

Source: EUROSTAT, COMEXT database.

Intra-industry trade has been expanding very rapidly between the CEECs and the EU (Figure 2). Intra-industry trade is important because it is one mechanism through which transfers of technology can occur. The Europe Agreements with the CEECs have created incentives for EU suppliers/retailers to engage in so-called outward processing trade (OPT). This consists of shipping components or assemblies to a CEEC where further processing occurs. The processed good is then

Figure 2



exported back to the EU supplier/retailer. Such processing trade benefits from liberal access to the EU, and has been used intensively for sectors such as garments, electrical machinery and furniture. As part of the subcontracting that is involved, EU counterparts will often provide designs, monitor quality, take care of marketing, etc. This is a good way for firms in partner countries to reduce the costs and risks associated with development of export markets, while at the same time obtaining know-how from suppliers. While OPT is frequently restricted, at least in the initial stages, to labor intensive, low value added activities, these can create significant employment.

In the period following the implementation of the agreements with the CEECs, exports after outward processing accounted for about 18 percent of total CEEC exports to the EU in 1993, up from 10 percent in 1989. For Romania, processing activities generated 30 percent of exports to the EU in 1993. In contrast, exports to the EU of processed goods represented only 1.7 percent of total MENA exports in 1993, a share that has remained constant since 1989 (Table 2). Most of the processing occurs in leather/footwear, clothing, electrical machinery, precision instruments and furniture. OPT accounts for a substantial share (about one quarter) of the growth in exports from the CEECs to the

EU (Hoekman, 1995a). In contrast, it plays a very minor role in MENA, the two exceptions being Morocco and Tunisia.<sup>7</sup>

**Table 2: Exports After Outward Processing (Share in Total exports to EU)**

	CEEC		MENA	
	1989	1993	1989	1993
<b>Total</b>	10.4	17.9	1.6	1.7
<b>Leather</b>	38.9	34.5	8.0	8.5
<b>Garments</b>	60.8	74.5	15.6	11.1
<b>Machinery</b>	8.1	14.4	5.4	2.6
<b>Transport</b>	12.3	4.7	4.5	2.3
<b>Instruments</b>	6.4	11.9	6.5	2.5
<b>Furniture</b>	26.5	13.9	1.2	1.5

Source: EUROSTAT, COMEXT database.

The data reveal clearly that the CEECs are moving rapidly to exploit their geographic proximity to the EU, which in conjunction with their relatively low wages and significant stocks of human capital makes them formidable competitors for the MENA region. The geographic advantage that the MENA region used to have--because Eastern Europe was effectively closed to open exchange with the West--has now disappeared. MENA firms must now compete head-to-head with companies located in the CEECs. This is indeed a challenge, not least because relative labor costs in the CEECs and MENA are not that different. Per capita incomes in the CEECs--one proxy for such costs--are close to MENA levels (World Bank, 1995a). Although factor endowments differ in important respects, it is also noteworthy that some of the CEECs are producing and exporting similar products to the EU. Correlation coefficients between revealed comparative advantage indices<sup>8</sup> of MENA and CEEC countries are sometimes significant. Table 3 reports those cases where such correlation coefficients are above 0.1. In general, however, the data suggest that competition between firm located in different CEECs is more intense than that between the two regions.

<sup>7</sup> The welfare implications of OPT may be ambiguous, insofar as the policy regime induces EU sourcing of inputs that are more costly than what is available on the world market.

<sup>8</sup> The RCA is defined as:

$$\frac{x_{ij}/X_j}{\sum_{i=1}^N x_i / \sum_{i=1}^N X_i}$$

where  $x_{ij}$  are exports of commodity  $i$  by country  $j$ ,  $X_j$  are country  $j$ 's total exports, and  $N$  is the number of countries.

**Table 3: Correlation Coefficients Between Revealed Comparative Advantage Indices, 1994**

	Bulgaria	Czech Republic	Hungary	Poland	Romania
Bulgaria	1.00				
Czech Rep.	0.19	1.00			
Hungary	0.37	0.23	1.00		
Poland	0.48	0.47	0.60	1.00	
Romania	0.33	0.49	0.48	0.60	1.00
Jordan	0.23	0.14	0.05	0.22	0.08
Lebanon	0.23	0.03	0.17	0.08	0.06
Syria	0.01	0.01	0.13	-0.01	0.01
Tunisia	0.17	0.01	0.01	0.07	0.22
UAE	0.11	0.04	0.26	0.26	0.20
ALL MENA	0.13	0.02	0.05	0.05	0.06

The extent to which the export performance of the CEECs is due to the Europe Agreements is very difficult to determine. It can be argued that to a large extent much of this would have been realized if the CEECs that were GATT contracting parties had simply locked in their trade liberalization through the WTO. Indeed, the GATT played a significant role in locking in CEEC trade policy reforms, as most of the CEECs had low, bound tariffs. Once centralized trade was abolished, GATT commitments ensured a substantial amount of discipline. However, the Europe Agreements go far beyond the WTO, basically extending much of the EU's Single Market rules to the CEECs. They provided an important political signal that the CEECs could aspire to membership of the EU--something that was acknowledged explicitly by the EU in June 1993 during the Copenhagen summit. They thus greatly reduced uncertainty for investors regarding the future policy environment. There are differences in opinion regarding the extent to which Agreements were instrumental in preventing the re-imposition of protection. Sapir (1995) argues that at least in the case of Hungary, the Agreement helped the Government resist pressures for protection;<sup>9</sup> Csaba (1995) argues that the Europe Agreements are too narrow in scope to create the institutional infrastructure needed to maintain a free trade stance. In his view it is the credible prospect of EU membership that is the key dimension in the CEEC context, as it is only this that will fundamentally constrain the use of various non-tariff barriers.

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<sup>9</sup> Indeed, he also notes that the WTO was not considered a binding constraint by the Hungarian government; what counted was the commitment towards the EU.

EU membership is not on the Mediterranean agenda. As far as MENA is concerned, the CEEC experience under the Europe Agreements that is perhaps of greatest relevance is the importance of OPT in driving export performance. While a EMA may enhance the incentives to use OPT, it should be recognized that MENA countries already have access to this customs regime. The lack of OPT in the MENA region suggests the existence of administrative or regulatory barriers in MENA countries. These may be offset to some extent under a EMA through harmonization of procedures and technical assistance (economic cooperation). Action in this area is a priority to generate an export supply response.

#### **IV. THE EURO-MEDITERRANEAN AGREEMENT WITH TUNISIA**

Currently, economic relations between Mediterranean countries and the EU are governed by Cooperation Agreements dating from the 1970s. These agreements are unlimited in duration, and provide duty-free access to EU markets for industrial goods, and preferential access for agricultural commodities. The agreements are not reciprocal in that partner countries may continue to apply MFN tariffs to goods of EU origin. They are complemented by Financial Protocols, which establish the amount of financial resources the EU will provide each partner country over a five year period. The key changes that will be implied by a EMA is a move to reciprocal free trade in industrial goods, and the replacement of Financial Protocols with EMA-specific financial cooperation (see below).

The basic objectives of the Euro-Med proposal are to: achieve reciprocal free trade between the EU and Mediterranean countries in most manufactured goods; grant preferential and reciprocal access for agricultural products; establish conditions for gradual liberalization of trade in services and capital; and encourage the economic integration of Mediterranean countries. The goals and constraints imposed by Mediterranean countries are perhaps best stated in the EU Commission's request for negotiating authority: "in order to be able to enter progressively into free trade with the Union and to take on board a wide range of trade-related Community regulations (customs, standards, competition, intellectual property protection, liberalization of services, free capital movements, etc.) ... Mediterranean countries ... insist on four fundamental aspects ....: the need for long transitional mechanisms and secure safeguards; the need to obtain improved access for their agricultural exports; the need for increased financial flows ... [and] the possibility to count on the Community's help to accelerate the modernization of their social and economic systems."<sup>10</sup>

The first Euro-Med Agreement (EMA), negotiated with Tunisia, was initialed in April and signed in July 1995 (Hamdouch, 1995). As it is very similar in structure to the other agreements that were concluded subsequently (Morocco) or are still being negotiated at the time of writing (Egypt, Jordan, Lebanon) what follows restricts attention to the Tunisian EMA. The agreement is unlimited in duration and is to be implemented over a twelve year period. Its operation is overseen by an Association Council (meeting at Ministerial level at least once a year) and an Association Committee (meeting at the level of officials, responsible for implementation of the Agreement). The EMA has

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<sup>10</sup> "Strengthening the Mediterranean Policy of the European Union: Establishing a Euro-Mediterranean Partnership," Communication from the Commission to the Council and the Parliament, October 1994.

six major elements: (1) political dialogue; (2) free movement of goods; (3) right of establishment and supply of services; (4) payments, capital, competition and other economic provisions (e.g., safeguards); (5) economic, social and cultural cooperation; and (6) financial cooperation. The structure of the EMA is similar to those of the Europe Agreements with the CEECs. The major difference is that no commitment has been made by the EU that the longer term goal is accession by partner countries. Many of the provisions of the EMA are conditional upon the date it enters into force (e.g., timing of tariff reductions). This in turn depends on how long it will take the 15 EU Member States and the Tunisian parliament to ratify the agreement.

*Free Movement of Goods.* As noted above, Tunisia already benefits from duty-free access to EU markets for manufactured goods under the 1976 Cooperation Agreement, and additional Protocols (1982, 1988) negotiated after the enlargement of the EU in 1981 and 1986. This implies that liberalization will mostly occur on the Tunisian side. As discussed below, the area where Tunisia potentially stands to gain significantly in terms of greater export opportunities--agriculture--was largely removed from the table. Quotas are to be abolished upon the entry into force of the agreement--except as allowed by GATT rules. In contrast to the CEEC Agreements, no special treatment was given to Tunisia as regards more rapid elimination of textile quotas than agreed under the GATT. However, Tunisia is reportedly only subject to two quotas, neither of which is close to being fully utilized (World Bank, 1994). Tunisia committed itself to gradually reducing tariffs on industrial products of EU origin to zero. Five groups of products--at the 7-digit Community Common Nomenclature (CN) level--have been defined in this connection. Four of these groups have been defined explicitly in Annexes. Tariffs for the fifth group, the residual (i.e., manufactured product that are not mentioned in one of the Annexes) will be abolished upon the entry into force of the agreement. There are 470 6-digit tariff lines in this group, all of which are either intermediate inputs or machinery (capital goods), accounting for 10 percent of 1994 imports from the EU (Table 4).<sup>11</sup> Annex 3 to the Agreement contains a list of products for which tariffs and surcharges will be eliminated over a 5 year period in steps of 15 percent, starting from the entry into force of the treaty. Products on this list, together with the group of goods to be liberalized immediately (i.e., those not mentioned in an Annex) account for some 35 percent of 1994 imports by Tunisia. Annex 4 comprises a list of products that will be liberalized over the full 12 year period transition period, in steps of 8 percent per year. Products listed in Annex 5 will commence tariff reductions four years after the entry into force of the agreement, with reductions spread out linearly over the remaining 8 years of the transition period (i.e., annual cuts of 11-12 percent). A final list of manufactured products contained in Annex 6 is exempted from tariff reductions. This list contains 37 6-digit tariff lines, comprising bread, pasta, and carpets.

Import weighted average tariffs applying to the groups of goods to be liberalized range from 21 to 34 percent (Table 4). Goods to be liberalized immediately have the lowest average tariffs, while those to be liberalized last have the highest average rates. Liberalization of intermediate inputs and capital

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<sup>11</sup> Trade data reported by EUROSTAT is either on a 6 or 8-digit level basis, making it impossible to relate exactly the tariff commitments (which use 7-digits) to publicly available trade statistics. However, in most cases, a concordance from the 7 to the 6-digit level was straightforward.

goods is front-loaded, whereas liberalization of consumer goods has been back-loaded. Some 90 percent of the goods in Annexes 3 and 4 are intermediates or machinery; as compared to only 4 percent for Annex 5. It is suggestive that some 75 percent of 1994 Tunisian exports to the EU involve goods contained in Annex 5. These products accounted for over 40 percent of domestic production in 1992. Annex 4 covers another 20 percent of domestic output. Much of domestic industry is therefore subject to gradual and back-loaded liberalization. Although this might be defended by arguing that it will assist the domestic industries concerned to prepare for greater competition from imports in the future (in part by raising effective protection through the more rapid reduction in tariffs on inputs and capital goods), there is no guarantee this will occur. Much depends here on the perceived credibility of the government's commitment to the EU, and on the use of provisions allowing for safeguard protection to be imposed. Insofar as the increase in effective protection of domestic industries during the first part of the implementation period leads to inefficient investment or non-adjustment, pressures may emerge in the future to resist market opening or impose safeguard actions. Moreover, the transition path chosen implies that there may be static welfare losses quite apart from the revenue transfer problem identified by Panagariya (1995), because the effective rate of protection increases during the first part of the transition.<sup>12</sup>

The approach taken by Tunisia with respect to tariff elimination is similar to that of the CEECs, albeit much more gradual. Poland committed itself to eliminate tariffs on about 30% of its imports from the EU in 1992, and to abolish the remainder over a seven year transition period, with duty reductions taking place during the last four years. Hungary agreed to liberalize 12-13% of its imports over a three year period in annual steps of one-third, another 20% between 1995 and 1997, again in steps of one-third and the rest (two-thirds) between 1995 and 2001, in steps of one-sixth per year. The Czech and Slovak Republics dismantle tariffs over a seven year period (like Poland, but somewhat less front-loaded). In addition to the speed of liberalization, another important difference is that initial tariffs in Tunisia and the Mediterranean more generally are much higher than in the CEECs (see Appendix Table 1). Average protection levels in the CEECs are in the 6% range, as compared to over 15 percent for many Mediterranean countries. For manufacturing, the differences are even greater, given that the average protection rate is in the 20-30 percent range.

A possible factor underlying the back-loaded nature of the tariff reduction process is that the government may have been concerned with the revenue implications of a more uniform move to free trade with the EU. The dependence on trade taxes in Tunisia--as in the other countries of the region--is relatively high. Some 28 percent of government revenues are derived from trade taxes. The EU accounts for 68 percent of total imports, and generates 58 percent of total tariff revenue. Most of the tariff revenue generated from trade with the EU is currently collected on the imports of consumer goods (Annex 5) whose liberalization is back-loaded, as compared to intermediates and capital goods. Annex 5 accounts for 33 percent of total revenues, as compared to 12 and 9 percent, respectively, for Annexes 3 and 4 (Table 4). Noteworthy in this connection is that the goods to be liberalized immediately generate only 3.6 percent of total revenue. While the approach taken minimizes revenue

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<sup>12</sup> This is because firms get access to cheaper inputs and input tariffs fall to zero, while continuing to benefit from tariffs on the goods they produce.



losses early in the program, the revenue constraint could have been addressed in a more uniform tariff reduction scenario. Alternative tax bases (excises, a VAT) exist in Tunisia.

**Table 4: Tariff Liberalization: Commitments by Tunisia (Industrial Products)**

	Share of trade		Share in domestic output	Share in total tariff revenue	Import weighted average tariff	Number of 6-digit lines Total=5019		Share of Machinery and Intermediates	
	Exp	Imp					% of total	by line (%)	by import value (%)
ANNEX 3: 5 year transition	16	24	20	12.5	26.7	1810	41	93	87
ANNEX 4: 12 year transition	7	29	22	9.2	30.4	1127	26	94	89
ANNEX 5: 8 year transition starting in year 5	75	36	43	32.9	33.8	944	22	8	4
ANNEX 6: Exempted	1	1	1	n.a.	n.a.	37	1	0	0
Industrial goods not listed in an Annex: Immediate liberalization	1	10	14	3.6	21.6	470	10	100	100

**Source:** Own calculations based on COMEXT and World Bank data. All data are for 1994.

*Agriculture* A distinguishing feature of the EMA is that little will change as far as agricultural trade is concerned. The objective of the EMA is to gradually liberalize trade in this sector. However, all it does in concrete terms is to largely lock in the status quo (existing preferential arrangements), while offering only limited improvements in access for specific products through expansion of tariff quotas and reduction/elimination of tariffs for specific quotas. Negotiations to improve on existing agricultural concessions are to be initiated after January 1, 2000. In this respect there is a substantial difference with the CEEC agreements. The latter, while also excluding agriculture from the reach of free trade, do provide detailed provisions granting CEEC farmers preferential access to EU markets. Continued restrictions on exports to EU agricultural markets is a major factor reducing the benefits of an EMA for Mediterranean countries. For a number of these countries agricultural export potential is important. In the Moroccan case, for example, some 28 percent of exports to the EU are agricultural. Excluding this from liberalization seriously limits the potential welfare gains of an EMA. It is not that surprising therefore that the unwillingness (inability) of the EU Commission to significantly expand export opportunities was the stumbling block for Morocco to reaching agreement with the EU (Hamdouch, 1995).

*Establishment.* The right of establishment (i.e., freedom to engage in FDI is an objective in the EMA. Modalities to achieve this objective are to be determined by the Association Council. No specific language is devoted to this subject; no time path or target date is mentioned for the realization of the objective. This is an area where there is a great difference with the CEEC Agreements, where the right of establishment is a central element. Under the latter, the EU has granted free entry and national treatment to all firms from the CEECs from 1992 on, except in air and inland water transport and maritime cabotage. The CEECs also grant free entry and national treatment to EU firms, with transitional periods for certain sectors or activities.<sup>13</sup> This does not necessarily imply that FDI is restricted in Tunisia. However, it does signal that this was considered to be a "sensitive" issue, something that potential foreign investors may well take into account.

*Capital Movement.* The EMA only requires that capital flows related to direct investment in Tunisia by EU firms in companies formed in accordance with current laws can move freely, and that income can be liquidated and repatriated. The CEEC Agreements again go further by requiring free mobility of capital and unrestricted repatriation of profits and initial capital of firms that establish in partner countries. Payment flows (current account transactions) resulting from liberalization commitments under the CEEC agreements are also unrestricted. Full convertibility and liberalization of capital account transactions are longer term objectives, although no time frame is mentioned for their realization.

*Supply of Services.* Cross-border supply of services (i.e., cross-border trade) has been excluded from both the EMA and the CEEC Agreements. The latter state that trade in services is to be liberalized progressively, taking into account the development of the service sector in each of the CEECs. This includes provision through temporary movement of natural persons. No time frame is established for the liberalization of supply of services, nor is the achievement of freedom of supply of services mentioned explicitly as an ultimate objective. Separate disciplines are to be established for air and inland water transport after the entry into force of each agreement. During the transitional period, the CEECs are to progressively adopt legislation consistent with that of the EU existing at any time in the field of air and land transport insofar as this serves to achieve the liberalization objectives of the agreement. International maritime services are to be liberalized, signatories undertaking to apply effectively the principle of unrestricted access to the market and traffic on a commercial basis.

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<sup>13</sup> Poland, for example, granted immediate freedom of establishment and national treatment for construction and most manufacturing activities, with the exception of mining, processing of precious stones and metals, explosives, ammunition and weaponry, pharmaceuticals, alcohol, high voltage power lines and pipeline transportation. All but the last two activities are to be liberalized by the end of 1997, at which time most service sectors will also be liberalized (financial, legal and real estate services excepted). By the end of the transitional period (10 years under the CEEC Agreements) all sectors are to be liberalized, except for acquisition and sale of natural resources and agricultural land and forests. The Czech and Slovak agreements liberalize FDI in all sectors immediately, except for the defence industry; steel; mining; acquisition of state-owned assets under privatization; ownership, use, sale and rent of real property; and the financial service industry. These activities are to be liberalized by the end of the ten year transition period. The Hungarian agreement is similar to the other CEEC agreements except that it adds legal services and gambling, lottery and similar services to the list of activities excluded indefinitely.

The EMA simply refers to the obligations of each country established under the General Agreement on Trade in Services (GATS), which did not exist at the time the Europe Agreements were negotiated. Obligations under the GATS do not imply much, if any, liberalization (Hoekman, 1995b). MENA countries made very limited commitments under the GATS, subjecting less than 10 percent of their service sectors to the national treatment or market access principles (Hoekman, 1995a). No mention is made of maritime or air transport as in the CEEC agreements. The objective of the GATS is not "free trade" in services. In contrast, given the objective of accession to the EU, for the CEECs foreign investors know that free trade and investment *is* the goal. Even absent the accession issue, it can be argued that the non-reference to the GATS in the CEEC agreements implies a stronger commitment to liberalization than the EMA. While it is understandable that sensitivity may exist on the part of the EU regarding possible labor movement associated with the provision of services--something that may also play a role in the FDI/capital movement context--"reciprocity" concerns are not a good rationale for Mediterranean countries to abstain from making commitments in these areas.

*Competition Policy.* The EMA and Europe agreements are similar with respect to the requirement to adopt the basic competition rules of the EU, in particular with respect to collusive behavior, abuse of dominant position, and competition-distorting state aid (Articles 85, 86, and 92 of the Treaty of Rome), insofar as they affect trade between the Community and each partner country. Implementing rules are to be adopted by the Association Council within five years (as opposed to three under the CEEC Agreements). Until then, GATT rules with respect to countervailing of subsidies will apply. State-aid, compatible with EU rules for disadvantaged regions (Article 92.3(a) Treaty of Rome), can be applied to the entire territory of Tunisia during the first five years. Such regional aid may be given by EU governments to regions in their countries with per capita incomes that are substantially below average, or to areas where there is significant unemployment. The low level of per capita incomes in the Mediterranean countries in comparison to those of EU states should ensure that non-industry specific state aids will be unconstrained in the medium term. The agreements also provide for enhanced transparency of state aids, each party agreeing to provide annual reports on the total amount and distribution of the aid given.

In both the EMA and CEEC cases, antidumping remains applicable to trade flows between partners. This despite the agreement by Tunisia (and the CEECs) to apply EU competition disciplines. An implication is that the security of market access rationale for regional integration was not met. At the very least, the inclusion of an Article 91:2 Treaty of Rome analogue could have been included, under which it is required that as of the entry into force of the Treaty, products originating in one Member state and exported to another be free of duties, quotas and measures with similar effect if they are re-imported. That is, efforts are required to ensure that arbitrage is possible. That being said, it is certainly the case that the enforcement of competition laws in the MENA region is important, and could have major benefits in terms of ensuring that the benefits of trade liberalization are realized. Given the market structures existing in these countries (in particular the prevalence of state-owned enterprises), anti-competitive business practices may be a problem.

*The Intra-Mediterranean Dimension and Rules of Origin* An objective of the Tunisian agreement is to promote the integration of the Maghreb countries. More generally, the EU is in favor of greater integration of the economies of the Mediterranean countries. This is important, as the negotiation

of bilateral agreements between the EU and each of the Mediterranean countries would otherwise lead to a so-called hub-and-spoke system. A problem with such an arrangement is that it creates incentives for firms to locate in the 'hub', i.e., the EU, as this gives them barrier-free access to all the 'spokes'. All other things equal, this creates forces *against* inward foreign direct investment by EU-based firms producing tradable goods. Partly for this reason the CEECs established a Central European Free Trade Agreement (CEFTA). To avoid a hub-and-spoke system from emerging, Mediterranean countries are well advised to pursue a similar strategy.

Intra-regional trade in MENA is limited. In part this reflects the similarity in endowments, in part the non-competitiveness of processed and manufactured goods that are produced. However, while currently small in absolute value (some \$8.3 billion in 1990, or 8 percent of total exports), relative to the region's participation in world trade, intra-regional trade is already quite high (Yeats, 1994; Ekholm et al., 1995). Thus, the trade of Egypt, Jordan, Syria and Turkey with the region is four times more intensive than trade with the world as a whole. The only major economy in the region where intra-regional trade is clearly 'too low' is Israel. Given the differences in the factor endowments and per capita income between Israel and some of its neighbors, intra-regional trade should be able to grow substantially. More generally, intra-industry trade must expand if intra-regional trade is to grow substantially, as the endowments of many countries are quite similar. This has already been happening to some extent. Although most intra-regional trade was in oil and oil products a decade ago, the share of oil has fallen significantly, standing at only 35 percent in 1992 (as opposed to 80 percent in 1980). Existing intra-regional trade is to some (unknown) extent driven by barter deals and a web of preferential, commodity-specific "protocol trade" agreements. The latter involve preferential tariff rates on specific lists of goods of Arab origin. In conjunction with the finding that intra-regional trade is already quite high, this suggests that much of this trade may consist of the "wrong" goods, i.e., those in which countries do not have a comparative advantage (see also Lawrence, et al. 1995 on this issue). Exports to non-regional partner countries may give a less biased view of potential trade inside the region. There appears to be little complementarity between exports of many of the countries in the region, in particular in the Middle East (e.g., Egypt, Jordan, Israel, Syria--see Appendix Table 2).

The rules of origin that are included in a FTA with the EU and in possible intra-regional agreements are important as they will help determine the potential for trade diversion resulting from the FTA. The Tunisian agreement allows for cumulation for rules of origin purposes for products produced in Algeria and Morocco as well as the EU and Tunisia. This may help create backward and forward linkages between the Maghreb countries and enhance the potential for intra-industry trade. The extension of cumulation to other Mediterranean countries, and the CEECs, would be more beneficial to participants. This requires that barriers to intra-regional trade are eliminated, and that existing commodity-specific preferential trade agreements are converted into full-fledged free trade agreements. As noted earlier, this will also ensure that the emerging hub-and-spoke nature of the EU's web of trade agreements is reduced.

There are various Articles in the EMA which mention the intra-regional dimension. Article 1, outlining the objectives of the EMA lists integration of the Maghreb countries as one of the Agreement's aims. Article 43 (on scope of economic cooperation) mentions that one objective of

cooperation (i.e., technical assistance) is to "foster economic integration within the Maghreb using any measures likely to further such relations within the region." Article 45 (Regional cooperation) states among other things that Parties will support activities that foster intra-regional trade within the Maghreb. Intra-regional integration is therefore defined rather narrowly (Maghreb, not Mediterranean).

*Economic Cooperation* One-third of the Articles of the Tunisian EMA deal with cooperation in economic, social and cultural matters. The prime objective underlying economic cooperation is to target "first and foremost" activities "suffering the effects of internal constraints and difficulties or affected by the process of liberalizing Tunisia's economy as a whole, and more particularly by the liberalization of trade between Tunisia and the Community" (Article 43). Methods of economic cooperation mentioned in the EMA include information exchange, provision of expert services (consultants), joint ventures (e.g., the Euro-Partenariat program), and assistance with technical, administrative and regulatory matters. Specific areas mentioned in the EMA include regional cooperation, education and training, science and technology, the environment, modernization of industry (including agricultural processing), promotion and protection of investment (e.g., negotiating investment protection and double taxation treaties), standardization and conformity assessment (introduction of EU procedures/rules, upgrading Tunisian testing labs), approximation of economic legislation, financial services (supporting restructuring; improving auditing and supervision), agriculture and fisheries (modernization, diversification), transport (modernization and restructuring; management; quality upgrading), telecommunications and information technology (standardization, introduction of EDI and ISDN), energy, tourism, and statistics.

The various Articles alluded to above are largely oriented towards upgrading Tunisian infrastructure broadly defined (both physical and regulatory) and providing support for restructuring of the economy. This support is not just reflected in technical assistance and advice, but is supported by financial assistance as well (see below). The specific mentioning of an issue area under the economic cooperation chapter presumably signals that this is a legitimate subject for using EU financial resources. One area of great importance for many countries in the region is cooperation on customs matters (Article 59). The aim of such cooperation is the simplification of procedures, the introduction of the EU's Single Administrative Document and linking EU and Tunisian transit systems. Active cooperation on these matters will be important for trade facilitation. Another issue area that is important is standardization and conformity assessment. The longer run objective of the EMA is to conclude agreements for the mutual recognition of certification (Article 40).

*Social and Cultural Cooperation* This includes a number of Articles guaranteeing national treatment for Tunisian and EU nationals that have found legitimate employment in the partner country. As far as movement of workers is concerned, Parties are only committed to "dialogue" aimed at achieving progress in this area. Priority is to be given to projects and programs to reduce migratory pressure, inter alia by creating jobs and developing training in areas from which emigrants come; promoting the role of women through education; improving social protection and health cover systems; and improve living conditions in poor, densely populated areas (Article 71).

*Financial Cooperation* As mentioned earlier, Mediterranean countries have received financial transfers from the EU under auspices of revolving 5-year Financial Protocols. The sums involved vary per country, but are significant. During the period of the Fourth Protocol (1991-96), Tunisia was allocated a total of ECU 284 million.<sup>14</sup> Under the EMA approach, financial protocols will not be renewed. Instead, the EU envisages earmarking a total amount of assistance--grants and loans--for all the Mediterranean countries. Individual allocations out of this total would not be pre-determined, but would in part be endogenous--depending on country performance, including the implementation of the EMA. Although not spelled out explicitly in the EMA, the Articles in the EMA on financial cooperation put emphasis on the link between EMA implementation and the provision of financial resources.

Article 75 of the Tunisian EMA states that "With a view to full attainment on the Agreement's objectives, financial cooperation ... shall entail:

- facilitating reforms aimed at modernizing the economy;
- updating economic infrastructure;
- promoting private investment and job creation activities;
- taking into account the effects of the progressive introduction of a free trade area on the Tunisian economy, in particular where the updating and restructuring of industry is concerned;
- flanking measures for policies implemented in the social sectors.

Moreover, Article 76 goes on to say that the Community will examine ways to support structural adjustment policies needed to restore financial equilibrium, while Article 77 seeks to establish a basis for coordinated approaches to dealing with "exceptional macroeconomic and financial problems which could stem from the progressive implementation of the Agreement." However, the exact modalities of financial cooperation are vague, the relevant procedures to "be adopted by mutual agreement between the Parties by means of the most suitable instruments once the Agreement enters into force" (Article 75). How future financial transfers will compare to past flows remains to be seen, although the absolute value of transfers is expected to increase. Some ECU 4.7 billion has been earmarked to support Mediterranean countries, to be complemented by an equivalent amount of European Investment Bank resources.

## **Evaluation**

To what extent will the EMA help MENA countries catch up with the CEECs? In principle, the liberalization of trade should do much to induce firms to upgrade their production capacity and improve their efficiency. In the long run the EMA is likely to be beneficial to all of the countries involved. But it should be remembered that in principle the exercise may be economically welfare-reducing in the short- to medium-run. Even if not, there can easily be significant opportunity costs

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<sup>14</sup> The amounts have been steadily increasing in nominal terms. During 1978-81, Tunisia obtained ECU 95 million. This rose to ECU 139 during 1981-86 and ECU 224 during 1986-91.

associated with preferential trading arrangements. The EMA's major potential advantage is that it provides a commitment mechanism to MENA governments, allowing a gradual reform path to be more credible than otherwise. Credibility may be enhanced through the binding nature of the agreement, the implicit linkage that has been made between official financial transfers from the EU and implementation of the EMA, and the offer of wide-ranging technical assistance to help Mediterranean countries improve the administration of their regulatory regimes (e.g., customs; certification of product standards).

However, the absence of binding commitments in the areas of direct investment and supply of services, and the maintenance of antidumping, suggests that one potential justification for regional arrangements mentioned in Section II has not been met. That is, the EMA does not go significantly beyond existing multilateral (WTO) disciplines. Moreover, the transition path to free trade with the EU is a long one, with liberalization of goods competing with domestic production only starting five years after the entry into force of the agreements. This may well reduce the incentives to initiate rapid restructuring, and may create problems in implementing tariff reductions in the future (e.g., through pressure for safeguard protection). The gradual liberalization may also be too slow in terms of maintaining existing export markets and capturing new ones in the face of increased competition from the CEECs and Asian economies, driven by the liberalization achieved in the Uruguay Round.

A potential rationale in favor of regional integration noted earlier is the existence of enforcement mechanisms that are more efficacious than those available under the WTO. In the EMA context, dispute settlement is dealt with by the Association Council. In the case of a dispute that cannot be addressed through consultations with the Council, one of the Parties may appoint an arbitrator. The other Party is then required to appoint a second arbitrator within two months, and the Association Council appoints a third one. Decisions by the three arbitrators will be taken by majority vote, with the Parties required to implement them. This goes beyond the WTO, where parties to a dispute are always free not to implement a recommendation by a WTO panel if they are willing to succumb to possible retaliation. Time will tell how this dispute settlement mechanism will work. It is important to note, however, that dispute settlement will only work if there are binding obligations. In a number of areas that are particularly relevant from a market access viewpoint such obligations have yet to be established, e.g., as regards product standards. Disputes on such issues, e.g., allegations that standards are used as non-tariff barriers, can only be dealt with by the WTO.

It is important that concurrently with the implementation of the EMA, external barriers to trade and foreign investment are reduced as well. A key issue here is the trade diversion question--the extent to which a shift away from efficient third country suppliers toward less efficient EU firms occurs, and the efficiency losses and implicit tariff revenue transfer that is associated with this. Given the lack of enhanced market access for Tunisian agricultural products, the extent of possible trade creation gains were limited. Much also depends in this connection on the value of the economic and financial cooperation that will flow from the EU to Tunisia (and the other Mediterranean partners). Another potential problem that may arise in this connection is the reliance on customs tariff for government revenue. As tariffs on EU goods decline to zero, if alternative tax bases are not created it may prove difficult to reduce MFN rates.

Of course, these are all potential problems, and arguments can be made to defend the liberalization strategy that was chosen. Thus, it may well be that by lowering tariffs on intermediates and capital goods first, domestic industries are granted some up front compensation for the adjustment costs that must be incurred later, and are given time in which to restructure. It could also be argued that this strategy ensures that tariff revenues will initially decline slowly, again giving more time to create alternative sources of funds for the Government. But the possible downside of the strategy should be recognized. Very much clearly depends on the extent to which complementary actions are pursued to improve the functioning of the economy. Important in this connection is the fact that the EMA does little to ensure investors of national treatment or to grant the general right of establishment. This is a significant difference with the CEEC Agreements, which clearly spell out that right of establishment is a central part of the deal. Such establishment is permitted immediately for most activities, and a transition path is spelled out for the remainder. By signalling the fact that they are open to FDI and willing to lock this in, the CEECs increased the incentives for foreign firms to establish and transfer much needed know-how by reducing political risk. FDI is especially important in the services area, where establishment often remains the best way to contest a market. Efficient services are crucial in terms of being able to participate in the global economy: telecommunications, information technology, port services, financial intermediation, and business support services are all key elements underlying the ability to compete on world markets. By limiting commitments to those made in the GATS, the EMA risks sending a signal that liberalization is not on the immediate agenda. It also puts the burden on unilateral efforts by Mediterranean countries to move forward.

An important factor underlying CEEC export performance is the fact that firms are able to exploit sub-contracting of manufacturing products for export to the EU in a much greater degree than most MENA countries. Such OPT is important, as it greatly facilitates the penetration of EU markets. Foreign (EU) partners generally take care of distribution and quality control. OPT activities are frequently time-sensitive. Under just-in-time management practices, the availability of adequate service links (transport, harbor services, customs operations, telecommunications ...) become fundamental for the decision on where to outsource. Geography suggests that many Mediterranean countries could become competitive locations for outsourcing by European companies if access to efficient producer services is made available. Morocco and Tunisia illustrate this, these being the only two MENA countries to make use of OPT. However, in many countries in the region significant changes in regulatory regimes and investment policies are required to improve the efficiency of service providers. Greater competition will do much to reduce price-cost margins and upgrade quality.

Actions to reduce the role of the state are particularly important. Indeed, the need to reform regulatory regimes affecting FDI and the operation of the service sector is part of a more general need to reduce the size of the public sector. Privatization of state-owned enterprises is a necessary condition for economic recovery and longer-run growth. Refraining from privatization will slow down the necessary adjustment process. Gradual implementation of free trade with the EU will put public sector enterprises under pressure to restructure, giving rise to pressure for assistance (subsidies; tax concessions; soft directed credit; capital infusions; increase in import barriers). The net costs of an EMA without a significant privatization effort are likely to be much higher than if the implementation of the EMA is complemented by deregulation and privatization. At the very least,



it would appear necessary that state firms confront hard budget constraints. Whether this is easier to achieve than privatization is an open question.<sup>15</sup>

There are important political economy issues here. Many MENA countries have a significant stock of educated workers that are either employed directly by the government administration or by state-owned firms. They also have large pools of unskilled, underemployed labor. In addition, some countries such as Egypt have a substantial stock of unemployed university graduates (World Bank, 1995b). A necessary condition for the implementation of the EMA to be politically feasible is that increased job opportunities for the unskilled and the educated unemployed materialize, and that job losses in the state sector remain politically manageable. Greater employment opportunities for the unskilled may emerge through the creation of firms specializing in labor-intensive production (in part through exploiting the OPT option) and by improving access for agricultural exports. The latter has been excluded; a necessary condition for the former is the existence of adequate infrastructure and the absence of red tape (regulations, tax administration, customs). As far as the more highly educated are concerned, many of the potential job opportunities lie in the service sector. Realizing this potential requires deregulating services activities and allowing establishment by foreign providers. Even then, realism suggests that in countries where the existing labor force employed in services is already significant, net losses may well occur initially. FDI can do much to stimulate both labor-intensive and more skilled activities, be they in services or manufacturing, but it will only materialize if the regulatory and institutional environment is conducive to private sector investment. Indeed, in the absence of improvements in the legal and regulatory framework, opening up to trade with the EU may result in greater competition from imports without much in the way of new investment. If so, the political viability of EMA implementation will decline. Much will also depend in this connection on how EU financial assistance is used. A strong case can be made that there may be a high payoff for using EU grants to fund worker compensation schemes to facilitate downsizing of the public sector (World Bank, 1995b). The wording of the Articles in the EMA on the scope and priorities for financial and economic cooperation is such that such funding should be possible.

## V. CONCLUSIONS

There is increasing evidence that trade liberalization and integration into the global economy is associated with higher rates of economic growth (Sachs and Warner, 1995). A problem confronting any government seeking to shift from an inward-looking to an export-oriented trade regime is the need to offset resistance by interest groups that are likely to lose in the transition to a liberal environment. In the mid to late 1980s, this political economy constraint was overcome by many countries in Latin America and Central and Eastern Europe as the result of external developments--the debt crisis, the fall of communism. In conjunction with the promise of large private financial inflows in the case of Latin America, and integration into Europe in the case of the CEECs, governments were able to "sell" broad-based economic reform (Rodrik, 1995). The MENA region

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<sup>15</sup> In general, the answer may well be yes if the Government desires to reduce resource flows to the public sector enterprises. By imposing an aggregate ceiling on the amount of such transfers, it may be able to insulate itself somewhat from individual claimants. Much depends here on the objective of the Government.

did not participate in the "shock approach" to reform. It pursued a very gradual reform path. In part this was because governments were not convinced of the need for wide-ranging market opening--there was no external factor similar to debt in Latin America--but perhaps more importantly because of the political costs that were expected from pursuing such a course.

The CEECs illustrate that far-reaching liberalization and a strategy of greater integration with the EU *and* the rest of the world will greatly expand trade and export-oriented production. Although the transition has been painful, the CEECs are now all experiencing real growth. The Europe Agreements are by no means the primary factor underlying CEEC economic performance, but they probably have been an important element in anchoring expectations. The EMA option provides a unique opportunity to the Mediterranean countries to credibly pursue far-reaching liberalization of trade in a gradual fashion. In this respect they are therefore very beneficial. But in themselves the EMAs are not enough. They are limited to the liberalization of trade in manufactured products. They do little more than contain hortatory language as regards the liberalization of service markets and foreign investment, something that is required to help ensure a supply response and create new employment opportunities.

The absence of commitments in these areas may be related in part to the issue of privatization and the role of the State. Without public sector reform--at a minimum the introduction of hard budget constraints--the impact of trade liberalization will both be muted and possibly more intense. The impact may be muted because public enterprises are given preferential treatment and retain substantial market power. The impact may be exacerbated if public enterprises are forced to adjust, but new employment opportunities do not emerge because barriers to entry continue to exist. The recent literature evaluating alternative explanations for the success of particular countries in attaining and sustaining high rates of economic growth concludes that while openness to the world economy is very important, in itself it is not enough. Equally important are efficient public institutions, domestic competition, a well-functioning service sector (finance, infrastructure, distribution, etc.), investment in human resources (education), high rates of private saving and investment, and a stable macro-economy. These factors cannot all be "imported" through an agreement with the EU. Some, however, could have been included in the EMA, thereby reducing the burden on Mediterranean countries to unilaterally pursue the reforms needed. As emphasized earlier, the policy regimes pertaining to FDI and the service sector are of particular importance in this connection. By not committing to a concrete transition path to achieve a liberal environment for these areas, an opportunity was missed, especially considering the magnitude of the (flight) capital owned by nationals of the region (World Bank, 1995a).

A similar conclusion can be drawn with respect to the issue of the long-term goal as regards the level of MFN tariffs that will be imposed on third countries. As noted in Section II, one way for a regional agreement to be unambiguously welfare-improving is if the EMA is used as a deliberate strategy to offset existing political economy constraints on unilateral liberalization through the use of the financial and economic assistance that is on offer. Although this may indeed be the objective of Governments in the region, they have not publicized it. Without such an explicitly stated long-term perspective, it may prove more difficult than otherwise for Governments to reduce MFN tariffs substantially in the future. This is because incentives will be created for not only domestic firms to seek to continue

to benefit from somewhat sheltered home markets, but EU firms fearing competition from third countries may also be induced to lobby for protection to be maintained. A clear time-table and transition path to be pursued concurrently with the implementation of the EMA would do much to avoid such problems, and provide a strong signal to domestic producers that what ultimately counts is not the regional market, but the world market.

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**Appendix Table 1: Trade Taxes in MENA and East European Countries, 1993**

	Share of Import Duties in Total Government Revenue	Share of "Other" Taxes in Total Import Tax Revenue	Average Collected Tariff (revenue/ imports)
Morocco	17.7	52	17.5
Tunisia	28.3	46	18.7
Egypt	10.0	8	14.9
Jordan	35.9	40	17.8
Syria	10.0	25	16.4
Oman	3.2	--	3.0
UAE	--	--	--
Yemen	20.2	3	19.1 <sup>+</sup>
Bahrain	9.2	--	4.0
Bulgaria	4.6	17	7.9
Czech Rep.	3.9	23	2.2
Hungary (1991)	5.8	--	8.6
Poland	6.5	--	5.9
Romania	3.8	--	7.0

**Notes:** -- zero or negligible; \* Excludes stamp duties; + Valued at the average parallel market exchange rate, the average collection rate was around 8 percent.

**Source:** IMF Government Finance Statistics Yearbook, 1994; International Financial Statistics, 1994.

**Appendix Table 2: Correlation of RCA Indices of Exports to the EU, 1993**

	<b>JOR</b>	<b>LEB</b>	<b>SYR</b>	<b>ALG</b>	<b>SA</b>	<b>KUW</b>	<b>TUN</b>	<b>UAE</b>	<b>MOR</b>	<b>ISR</b>	<b>EGY</b>
<b>JORDAN</b>	1.00										
<b>LEBANON</b>	-0.02	1.00									
<b>SYRIA</b>	0.01	0.44	1.00								
<b>ALGERIA</b>	-0.04	-0.04	0.25	1.00							
<b>SAUDI ARABIA</b>	0.01	-0.04	0.55	0.46	1.00						
<b>KUWAIT</b>	0.09	-0.01	0.56	0.46	0.95	1.00					
<b>TUNISIA</b>	0.16	0.01	-0.01	0.39	-0.04	-0.02	1.00				
<b>U.A.E.</b>	0.10	0.07	0.14	0.02	0.17	0.22	0.12	1.00			
<b>MOROCCO</b>	0.17	0.00	-0.03	0.65	-0.05	-0.04	0.64	-0.00	1.00		
<b>ISRAEL</b>	0.21	-0.03	-0.07	-0.07	-0.05	-0.06	0.09	-0.04	0.14	1.00	
<b>EGYPT</b>	0.09	0.12	0.63	0.11	0.30	0.32	0.10	0.17	0.05	0.00	1.00

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